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GLOBAL INVESTMENTS

Doll's Deliberations

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In this short essay, we highlight some of the most important drivers for the economic and investment outlook. The essay is not exhaustive on any subject, nor does it touch on the long list of subjects impacting the investment environment. We will be more comprehensive with our Ten Predictions at year-end.

We expect stocks and bonds to be range-bound and in trading ranges for the balance of the year – so no big call. Short term, stocks are becoming overbought, but remain with reasonably good momentum. Sentiment, which was bearish at the turn of the year, was bullish by the July 31 high, then turned neutral, is now turning bullish again. Company comments can be summarized as "things have been good, but they are weakening – we just don't know by how much."
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ECONOMIC GROWTH

We expect real GDP growth to slow considerably in Q4 as consumer spending starts to move more in line with income. Though it is early in the quarter for tracking estimates, the Atlanta Fed's GDPNow measure is consistent with this view, as it is currently looking for Q4 real GDP growth of 2%. The Fed would like to see nonfarm payroll growth stay at the +100k per month as seen for October, a number that is more consistent with a stable unemployment rate than the strong readings seen in prior months.

THE FED AND INTEREST RATES

The bar to hike rates again is high, and the Fed is unlikely to raise in the near future. But the Fed is unlikely to cut interest rates by mid-year 2024 as the consensus is expecting, and, if there is no recession, rate cuts may not happen in all of 2024. Chair Powell has said that "we're not confident yet" that policy was restrictive enough to put inflation on a path to 2% over time. But he did note that the Fed saw the risk to its policy rate decisions now as being more two-sided than before. Additional monetary tightening will be warranted if growth remains persistently above potential, and if the labor market's tightness persists, neither condition of which is likely. Our guess is that in the short-term economic growth and inflation will be much more important drivers of Treasury yields going forward than supply despite the supply problem stemming from the rising deficit and higher interest rates.

THE FISCAL SITUATION

The last time the U.S. had a budget surplus was before the September 11 terrorist attacks in 2001. The U.S. response, which included wars in both Afghanistan and Iraq, as well as the expansion of the federal government through the creation of a new federal agency in the Department of Homeland Security, quickly created a deficit. The debt grew, though it was relatively minor and therefore perceived to be manageable. The 2008 housing and financial crisis helped fuel a long period of very low interest rates.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	1.29%	8.84%
S&P 500	1.02%	20.52%
NASDAQ	0.90%	37.20%
RUSSELL 1000	0.95%	20.03%
RUSSELL 1000 GROWTH	1.06%	36.68%
RUSSELL 1000 VALUE	1.04%	4.77%
RUSSELL 2000	-0.11%	3.35%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	1.25%	52.09%
CONSUMER DISCRETIONARY	0.78%	33.81%
CONSUMER STAPLES	1.44%	-2.45%
ENERGY	0.25%	-0.77%
FINANCIALS	1.03%	4.90%
HEALTHCARE	2.26%	-2.28%
INDUSTRIALS	0.78%	9.71%
INFORMATION TECHNOLOGY	0.62%	51.75%
MATERIALS	1.06%	5.94%
REAL ESTATE	1.05%	0.83%
UTILITIES	0.69%	-8.90%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	0.86%	16.07%
MSCI ACWI EX U.S.	0.69%	9.50%
MSCI EAFE	0.53%	11.53%
MSCI EM	1.26%	5.78%

This meant the cost of servicing debt was relatively small. The pandemic response included another massive round of fiscal stimulus pushed by both the Trump and Biden administrations. The Biden administration added additional fiscal stimulus to promote its industrial policy as well as accelerating the transition to cleaner forms of energy. The arrival of non-transitory inflation and the rise in interest rates rapidly accelerated federal interest expense. Republicans seem unwilling to reduce taxes. Democrats seem reluctant to stop spending. Neither side wants to touch the entitlement programs, which drive 70% of mandatory spending. As a result, it is hard to see any appetite to change the current trajectory, which means more borrowing in the future, likely at higher interest rates to service a mounting debt obligation, which could throw more fuel on the inflation fire.

RISKS

Among the near-term risks are: 1) the war in the Middle East spreads threatening higher oil prices and 2) continued defense spending increases for Ukraine, Middle East, and Chinese defense causing bank vigilante and bond market disruption. The other well-known risks include out of control fiscal policy, a somewhat dysfunctional federal government, inflation increasing above the Fed's target, cracks showing up in the credit system, and the Chinese property market problems.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	0.31%	0.86%
BLOOMBERG U.S. CORP HIGH YIELD	0.46%	8.31%
BLOOMBERG U.S. GOV/ CREDIT	0.37%	1.21%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.06%	4.54%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	0.50%	-0.41%
COMMODITIES (DJ)	-0.28%	-5.70%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	1.20%	21.03%
CURRENCIES (DB CURRENCY FUTURE HARVEST)	0.42%	8.96%

THE LONG TERM

The outlook for a balanced portfolio over the next ten years is unimpressive by the standards of recent decades, reflecting the end of the era of low and/or falling interest rates. That era boosted valuations and returns for most asset classes and is still in the process of unwinding. Investors must beware extrapolating past returns into the future given the shift in the underlying macro backdrop. Real interest rates will still move in concert with the economic cycle, but consistently higher interest rates than in the past decade imply that returns for major asset classes and multi-asset portfolios will be lower than in the past several decades. Against an economic backdrop of moderate global growth and sticky (and above target) inflation, investors will need to align their expectations accordingly.

The most notable trend in global growth drivers in recent decades is the slowdown in global population and employment growth. This is especially the case in developed economies, but also China, whose population contracted marginally last year. Labor force and employment growth in most major economies will continue to slow as their populations age in the coming decades. A positive offset is that labor productivity growth has been solid at just over 2% annually over the past ten years.

There is considerable uncertainty about the longer-run outlook for global inflation. Major central banks remain committed to targeting consumer price inflation of 2%, but their ability and/or willingness to meet their targets is also contingent upon the extent to which economic growth must be sacrificed to do so. Ultimately, we expect most central banks to be willing to accept moderately above-target inflation in the future to secure steady GDP growth.

The marked rise in interest rates in the past two years has dramatically improved the long-run return prospects for fixed income portfolios. Nonetheless, it is important to stress that both policy rates and long-term bond yields will not revert to their levels in the 2010s, which were dampened by the U.S. and euro area deleveraging and reduced long-term inflation expectations. Instead, G7 yield curves will oscillate over the course of the cycle at average levels much closer to current levels than many investors have yet embraced, i.e., most still expect a return to low levels.

There have been two distinct trends driving the rise in stock prices over the past four decades. There was a dramatic re-rating of stocks (i.e., a rise in P/E ratio) as interest rates steadily declined, while real earnings rose only modestly. There was also a rise to an elevated level of return on equity (ROE) which will likely create a headwind for stock prices in the coming decade. ROE has historically been a mean-reverting series, implying that it will trend lower over the next decade. As a result, prospective corporate earnings should be expected to increase at a slower pace than economic growth, thereby constraining returns in the next decade.

CONCLUSIONS:

1. The lagged effects of the aggressive move of fed funds from zero to 5 ¼% in 18 months are not completely felt yet.

2. We are reasonably confident that inflation will continue to moderate but that the Fed's 2% target will remain elusive.

3. We continue to expect a mild recession over the next 6-12 months.

4. Double-digit earnings growth for 2024 seems very unlikely, even if we don't have a recession.

5. Fiscal policy is out of control. That the federal deficit doubled from $1 to $2 trillion in a moderate growth economy is downright scary. The fastest growing component of the federal budget is interest expense.

6. The tug-of-war between the bond bulls (who are focusing on falling inflation) and the bond bears (who are focusing on the mounting debt) will likely keep the 10-year Treasury yield near 4 ½% with the risk to the upside.

7. Equity valuations are extended. (P/E again approaching 20x.)

8. We expect the bond and stock markets to bounce around for the rest of this year as the bulls and bears alternate. (We have called for a 4200-4600 S&P trading range and expect that to prevail for the balance of the year.)

9. The geopolitical environment is treacherous.

10. Investors should prepare for lower long-term returns than enjoyed over the last few decades.

Data from Bloomberg, as of 11/24/2023.